

**CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
STATEMENT OF INVESTMENT POLICY**

**FOR
CURRENCY OVERLAY – EXTERNALLY MANAGED**

September 13, 1999

This Policy is effective immediately upon adoption and supersedes all previous externally managed currency overlay policies.

I. PURPOSE

This document sets forth the investment policy ("the Policy") for the Externally Managed Currency Overlay Program ("the Program"). The design of this Policy ensures that investors, managers, consultants, or other participants selected by the California Public Employees' Retirement System ("the System") take prudent and careful action while managing the Program. Additionally, use of this Policy provides assurance that there is sufficient flexibility in controlling investment risks and capturing opportunities as they may occur.

II. STRATEGIC OBJECTIVE

Lowering the return volatility of the International Equity Program is the strategic objective of the Program. This shall be accomplished through the partial hedging of the currency exposure in the developed markets portion of the System's Passive International Equity Index Fund. This partial hedge is currently targeted at 25%.

The Program shall employ techniques to balance risk reduction with hedging cost and cash flow management. Therefore, it is expected that only under rare circumstances shall the program result in a 100% hedged (zero currency volatility) exposure.

The Program shall be managed to accomplish the following:

- A. Protect the System's International Equity Program from incurring large currency losses during the near term (one-to-three years), at reasonable cost, with effective cash flow management in the settlement of derivative positions.

- B. Consider solely the interests of the System's participants and their beneficiaries in accordance with California State Law.

III. RESPONSIBILITIES AND DELEGATIONS

- A. The **System's Investment Committee** ("Investment Committee") is responsible for approving and amending the Policy and delegates the responsibility for administering the Currency Overlay portion of the System to the Investment Staff through the Delegation of Authority (Delegation Nos. 89-13 and 95-50).
- B. The **Investment Staff's** ("the Staff") duties include, but are not limited to, the following:
 - 1. Developing and recommending the Policy to the Investment Committee.
 - 2. Developing and maintaining a procedures manual, subject to periodic reviews and updates, outlining Staff operational procedures to be used in implementing this Policy.
 - 3. Implementing and adhering to the Policy.
 - 4. Recommending action concerning outside money management firm(s) ("Managers") retained under contract to implement the Program in accordance with the External Investment Manager and Currency Overlay Manager Monitoring Policy. Duties may include making recommendations with respect to changes in the Manager's contractual guidelines or regarding any other aspect the Staff considers pertinent.
 - 5. Reporting to the Investment Committee, as needed, about the performance of the segment. Monitor the implementation of, and compliance with, the Policy. Staff shall report concerns, problems, material changes, and all violations of Guidelines and Policies immediately and in writing to the Investment Committee. Reports to the Investment Committee shall include an explanation and appropriate recommendation(s) for corrective action.
- C. Each **Manager** is responsible for all aspects of portfolio management as set forth in each Managers' contract with the System and shall fulfill the following duties:

1. Communicate with the Staff, as needed, regarding investment strategy and results. The Manager shall monitor, analyze, and evaluate performance relative to the agreed-upon benchmark.
 2. Coordinate with the System's master custodial bank to ensure that there is a clear understanding of the currency exposures of the underlying portfolio(s) through which overlay of the Program exists.
 3. Cooperate fully with the System's Staff, Custodian, and General Pension Consultant on requests for information.
- D.** The **General Pension Consultant** shall monitor and evaluate the Managers' performance relative to the benchmark and Policy. The General Pension Consultant shall report to the Investment Committee quarterly in accordance with its contract.

IV. PERFORMANCE OBJECTIVES

The Currency Overlay Program controls risk rather than generate return. The Program shall achieve results specific to the prevailing currency market environment as follows:

- A.** In appreciating foreign currency environments, the Program shall seek to capture approximately sixty (60) percent of currency gains.
- B.** In depreciating foreign currency environments, the Program shall seek to limit losses to no more than three (3) percent below the fully hedged benchmark.
- C.** In flat or trendless environments, the Program shall approximate the benchmark results.

V. INVESTMENT APPROACHES AND PARAMETERS

A. Approach

1. The risk and return characteristics of the international equity assets subject to the Currency Overlay Program (hedged assets) shall differ significantly from the portion of the international equity assets outside the program. Therefore, different strategic risk and return assumptions shall be developed for the Program for asset allocation planning purposes, in accordance with the Strategic Asset Allocation Policy, incorporated herein by reference. The specific

allocation of assets subject to the Currency Overlay Program shall be determined by the financial analysis prescribed under the Strategic Asset Allocation Policy and shall vary within ranges prescribed therein.

2. Execution of the Currency Overlay Program shall occur through a portfolio(s)' investments in developed markets where currency market exposure is relatively predictable. Portfolios most suitable are passive index funds or semi-active approaches.
3. The Program shall be implemented through the retention of an external manager(s). The external manager selection shall occur in accordance with Section V.B. of this Policy.
4. The viability of the program shall be reviewed continually, with a formal review at least every five years.

B. External Manager Selection

1. The System shall retain Manager(s) recognized for their expertise in Currency Overlay Programs with a multiple-manager structure and in approved derivative management. The Manager(s) shall be registered, or appropriately exempt from registration, with the Securities and Exchange Commission.
2. Manager(s) shall be selected in accordance with the System's Contract and Procurement Policy.

C. Investment Parameters

1. The Manager(s) shall operate under a set of specific guidelines outlining their investment philosophies and approaches, representative portfolio characteristics, permissible and restricted securities and procedures, and performance objectives representative of their strategic role within the Program and the investment risk incurred.
2. Implementation of this Program shall comply at all times with the System's investment policies including, but not limited to, the following criteria:
 - a. Statement of Derivatives Policy for External Managers;

- b. External Investment Manager and Currency Overlay Manager Monitoring Policy; and
 - c. Manager-specific Investment Management Guidelines.
- 3. Manager(s) shall execute currency transactions over the long currency positions of the underlying portfolio(s) of assets assigned to them. These currency positions may be executed in either the forward currency markets or in related currency derivative instruments, subject to the policies specified in Section V.C.2. At no time shall Manager(s) assume any foreign equity positions in their own accounts.
- 4. The Manager(s) shall monitor their currency positions to avoid leverage regarding the net currency exposure of the underlying portfolio through a net long position in foreign currency forwards or a net short position once the hedge and the underlying portfolio are combined. Currency positions taken shall constitute a designated hedge of the actual international assets identified in the underlying portfolio.

VI. BENCHMARK

The benchmark for the Program shall be fully hedged and shall be a function of the International Equity Program as it may be implemented.

VII. GENERAL

- A. This Policy contains a glossary of terms in Section VIII of this document.
- B. Investors, managers, consultants, or other participants selected by the System shall make all calculations and computations on market-value basis, as recorded by the System's custodian.

VIII. GLOSSARY OF TERMS

The following Glossary of Terms contains definitions also referenced in the System's Master Glossary of Terms.

Currency – The monetary unit of a sovereign state.

Custodian – A bank or other financial institution providing custody of stock certificates and other assets of an institutional investor.

Derivative – An instrument whose value, usefulness, and marketability depends upon, or derives from, an underlying asset. Classes of derivatives include futures contracts, options, currency forward contracts, swaps, and options on futures.

Derivatives Policy –The System's Statement of Derivatives Investment Policy, Guidelines, and Procedures for External Money Managers, as most recently amended.

Developed Market – A country that most investors consider to have a well-developed operating and regulatory structure for its capital markets. Generally, countries included in the Financial Times-Actuaries Index are considered to be developed markets.

Forward Contract – A non-standardized contract for a deliverable commodity or instrument conveying the obligation to make or take delivery of that commodity or instrument at a future point in time for a specified price.

Futures Contract – A standardized contract for a deliverable commodity or instrument conveying the obligation to make or take delivery of, the commodity or instrument at a future point in time for a specified price.

Hedge, Hedging – Taking an investment position that counterbalances the risk of another position. Hedging is the offsetting of risk; diversification is the spreading of risk.

Option – An instrument conveying the right, but not the obligation, to buy or sell a deliverable instrument at a specified price.

Policy – The System's Investment Policy, Guidelines, and Procedures for Currency Overlay – Externally Managed.

Swap – A contract where the parties agree to exchange the cash flows of the underlying assets in amounts specified by the contract.